

Internal Revenue Service  
**memorandum**

CC:TL-R-799-87  
TL-N-3130-88  
Br4:KAAqui

date: **FEB 16 1988**

to: District Counsel, Dallas

CC:DAL

from: Director, Tax Litigation Division CC:TL

subject: [REDACTED]

By memorandum dated February 1, 1988, you requested technical advice in defense of the above-referenced case. Plaintiffs brought suit to recover \$ [REDACTED], plus statutory interest for taxable year [REDACTED].

ISSUE

Whether dry hole costs are properly includable in intangible drilling and development costs (IDC) for purposes of the recapture provisions of I.R.C. § 1254.

CONCLUSION

Dry hole costs are includable as IDC only to the extent the taxpayer recognizes income on the foreclosure of nonrecourse debt the proceeds from which were used to finance the IDC with respect to the property.

FACTS

During [REDACTED], plaintiffs were members of a general partnership, [REDACTED] which was engaged in the development and sale of oil and gas prospects. During [REDACTED], the partnership disposed of producing oil and gas leases and in reporting the sale of said properties on their original return, plaintiffs recaptured all IDC previously claimed with respect to said properties as ordinary income. Plaintiffs filed an amended return wherein a refund of taxes was sought by excluding from recapture the amount of dry hole costs claimed as IDC. By letter dated [REDACTED], the Service notified plaintiffs that their claim for refund was disallowed and this timely action ensued.

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### ANALYSIS

Section 263(c), in part, grants a taxpayer the option to deduct as expenses intangible drilling and development costs in the case of oil and gas wells.

Section 1254(a) provides that if oil, gas, or geothermal property is disposed of after December 31, 1975, the lower of (A) the aggregate amount of expenditures after December 31, 1975, which are allocable to such property and which have been deducted as intangible drilling and development costs under section 263(c) by taxpayer or any other person and which (but for being so deducted) would be reflected in the adjusted basis of such property (reduced by an amount by which the depletion deduction under section 611 would have been increased had the IDCs been capitalized and not expensed), or (B) the excess of the amount realized or the fair market value of the interest over its adjusted basis, shall be treated as gain which is ordinary income.

Section 1254(a)(3) defines "oil, gas, or geothermal property" as any property (within the meaning of section 614) with respect to which IDCs deducted under section 263(c) are properly chargeable.

Section 1254(b) provides in part that under regulations prescribed by the Secretary, rules similar to the rules of section 1245(b) shall apply. Section 1245(b) provides that certain dispositions, such as gifts, will not be subject to recapture.

A notice of proposed rule making concerning section 1254 was published in 1980. Prop. Treas. Reg. § 1.1254-1 through § 1.1254-5, 45 Fed. Reg. 39512 (1980). Prop. Treas. Reg. § 1.1254-1(a)(1) provides that upon disposition of an oil, gas or geothermal property, there shall be treated as gain which is ordinary income the lower of the amount of the adjusted intangible drilling and development costs (as defined later) with respect to the property, or the amount, if any, by which the amount realized on the disposition exceeds the adjusted basis in the property.

Prop. Reg. § 1.1254-1(a)(2) provides that the term "adjusted intangible drilling and development costs" means the aggregate amount of IDC claimed under section 263(c) with respect to the property reduced by the deduction for depletion allowed under section 611. The regulation further provides that the aggregate amount of expenditures allocable to the property includes the amount of expenditures properly allocable to nonproductive wells.

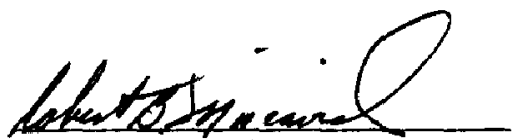
In response to these proposed regulations some commentators stated that IDC allocable to nonproductive wells should not be recaptured because they are not added to basis; instead, the operator normally deducts these amounts under Treas. Reg. § 1.612-4(b)(4) on the return for the first year after abandonment of a nonproductive well. Nevertheless, one of the reasons for enactment of section 1254 was to prevent, in certain limited risk situations, the conversion of IDC currently deducted against ordinary income into capital gains. H.R. Rep. No. 94-650, 94th Cong. 1st Sess. 94 (1975). Thus, the proposed regulation has been amended to provide that the aggregate amount of section 1254 costs paid or incurred on any section 1254 property includes the amount of costs incurred on nonproductive wells, but only to the extent that the taxpayer recognizes income on the foreclosure of a nonrecourse debt the proceeds from which were used to finance the IDC with respect to the property.

These regulations were submitted as final regulations to the Treasury Department in October 1987, and reflect current Service position. Accordingly, unless the plaintiff recognized income because of foreclosure nonrecourse debt used to finance the drilling and development of the property, plaintiff is not required to recapture dry hole costs claimed as IDC.

If you have any further questions concerning this matter, please contact Mr. Keith A. Agui at FTS 566-3308.

MARLENE GROSS  
Director

By:

  
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Senior Technician Reviewer  
Branch No. 4  
Tax Litigation Division

Attachment:  
Admin. File  
"Final" Regulations